

TEACHERS' RETIREMENT BOARD
INVESTMENT COMMITTEE

SUBJECT: Update on State Legislation (*Revised*)

ITEM NUMBER: 7

ATTACHMENT(S): 1

ACTION: X

MEETING DATE: June 7, 2000

INFORMATION:

PRESENTER: Ed Derman

SUMMARY

Staff has prepared the attached analysis and recommended position on the following measures for the Board's consideration:

<u>Attachment</u>	<u>Bill Number</u>	<u>Author</u>	<u>Subject</u>
1	AB 107	Knox	Tobacco divestment
2			Legislative Summary

Mr. Derman will provide an overview of the update on state legislation.

Assembly Bill 107

Assembly Member Knox (As amended 2/29/00)

Position:

Oppose (Staff recommendation)

Proponents:

CFT, CTA, UTLA

Opponents:

None known

SUMMARY

AB 107 prohibits new or additional investments in tobacco companies by the California State Teachers' Retirement System (CalSTRS) and the California Public Employees Retirement System (CalPERS), on and after January 1, 2001 and requires a divestment of existing investments by July 1, 2002.

HISTORY

In 1997, two tobacco divestment bills, AB 1744 (Knox) and SB 1433 (Hayden), were introduced but failed passage.

CURRENT PRACTICE

CalSTRS passively and actively invests a portfolio valued at over \$100 billion. The portfolio is broadly diversified and ranges from publicly traded bonds to privately held partnerships. At the end of last fiscal year, CalSTRS' portfolio allocation across asset classes was 70 percent domestic and international equity, 25 percent domestic fixed income, and 5 percent private equity. Currently, CalSTRS does not adhere to any investment policy restricting the holding of equities in any particular industry or sector in its portfolio, such as tobacco.

DISCUSSION

As of December 31, 1999, CalSTRS held domestic and international equities in 22 companies that manufacture and distribute tobacco products, at a market value of \$319,270,861, or less than one half of one percent of equity holdings. The bill (1) prohibits *new* or *additional* investments by CalSTRS and CalPERS in tobacco companies on and after January 1, 2001 and (2) requires the divestment of existing investments by July 1, 2002.

AB 107 defines a tobacco company broadly as “... a business entity that makes more than 10 percent of their gross revenue from tobacco products or have more than 10 percent of their personnel or has more than 10 percent of its business activity in tobacco products.” Such a definition could encompass the business activities of retailers, transportation companies,

chemical companies, flavoring companies, and advertisers resulting in a very long list of companies in the CalSTRS portfolio that would be targeted for divestment, with a market value exceeding the \$319 million for the 22 companies cited earlier.

As an investment sector, tobacco stocks have had mixed results during the past six years. At the April 2000 Investment Committee meeting, the Teachers' Retirement Board (Board) was informed by various consultants, including Pension Consulting Alliance, Inc., that tobacco divestment would not increase the overall risk of CalSTRS aggregate portfolio. However, the consultants could not determine what impact, if any, tobacco divestment would have on the future investment returns of CalSTRS' aggregate portfolio. As a result, the Board chose to address investments in tobacco in the context of larger investment policy issues: the benchmark the system uses to determine specific investments and the extent to which CalSTRS delegates investment portfolio decisions to external portfolio managers.

At the May 2000 Investment Committee meeting, the committee adopted a policy to modify the benchmark against which investments are measured. Under the policy, the benchmark will be modified when it is in the economic interest of the System to do so, when a more cost efficient alternative is available or when an industry is exposed to economic risk. The indicators of significant economic risk would include product liability judgments, industry-wide bankruptcy filings and regulatory and/or legislative actions. At the June committee meeting, the committee will determine whether the current economic conditions of the tobacco industry warrant application of the new policy. If so, then CalSTRS will cease its passive investment in the tobacco industry.

As a result, the Board has developed a policy that address the issue raised by this bill. As that level of risk may change over time, it is more appropriate that all decisions be maintained by the Board, rather than enacted in statute, which would require additional legislative action to modify in response to changing conditions.

FISCAL IMPACT

Benefit Program Costs – While the performance of the investment portfolio impacts the benefits CalSTRS may offer its membership, AB 107 does not directly impact the benefit programs.

Administrative Costs – The divestment of equities in tobacco companies as broadly defined would increase financial risk and reduce diversification of the investment portfolio. According to the BARRA Tobacco Divestiture Study of April 5, 2000, the divestment of tobacco company holdings would result in substantial transaction costs as tobacco equities are sold and the proceeds reinvested in other companies. BARRA estimates the cost of selling US tobacco holdings and reinvesting the proceeds for CalSTRS U.S. tobacco holdings to be approximately \$3.164 million or 1.48 percent of CalSTRS U.S. tobacco holdings. For the international portfolio, the estimated costs of selling CalSTRS tobacco related holdings and reinvesting the proceeds was estimated at \$1.191 million, or 1.02 percent of CalSTRS tobacco holdings.

In addition to these direct transaction costs, the BARRA study also found that tobacco divestiture increases the total risk of the portfolio as well as the portfolio's risk relative to the S&P 500 benchmark. This increased risk is equal to approximately two basis points (.02 percent) or \$22 million in the current CalSTRS portfolio. Depending on the time period measured, this figure represents the potential gain or loss to the portfolio as a result of tobacco divestiture.

RECOMMENDATION

Oppose. The Board has developed a process to evaluate whether the economic risk associated with particular investments warrants excluding them from the system's investment benchmarks. Continued investment in tobacco will be considered in light of that process. Maintaining that authority with the Board, rather than being enacted in statute, would permit the system's investments to be more responsive to changes in the investment climate.

[illegible]

LEGEND OF ABBREVIATIONS

P = PROPONENTS O = OPPONENTS

<u>ABBREVIATION</u>	<u>ORGANIZATION</u>
AALA	Associated Administrators of Los Angeles
ACCCA	Association of California Community College Administrators
ACSA	Association of California School Administrators
AFSCME	American Association of State, County and Municipal Employees
AFT	American Federation of Teachers
AGENCY	State and Consumer Services Agency
A.R.E.	Association of Retirees for Equity
ART	Association of Retired Teachers
BOE	Board of Equalization
BOG	Board of Governors, California Community Colleges
Cal-Tax	California Taxpayers Association
CalPERS	California Public Employees Retirement System
CalPIRG	California Public Interest Research Group
CalSTRS	California State Teachers' Retirement System
CASBO	California Association of School Business Officers
CCA	Community College Association
CCAE	California Council for Adult Education
CCC	California Community Colleges
CFA	California Faculty Association
CFT	California Federation of Teachers
CNEC	California Network of Educational Charters
CPCA	California Police Chiefs' Association
CPFFA	California Professional Firefighters Association
CRTA	California Retired Teachers Association
CSAC	California State Association of Counties
CSBA	California School Boards Association
CSEA	California School Employees Association
CSL	California Senior Legislature
CSU	California State University
CTA	California Teachers Association
DOE	Department of Education
DOF	Department of Finance
DGS	Department of General Services
DPA	Department of Personnel Administration
FACCC	Faculty Association of California Community Colleges
F.A.I.R.	Faculty Attempting to Improve Retirement
FCPHE	Faculty Coalition for Public Higher Education
FTB	Franchise Tax Board
LADSA	Los Angeles Deputy Sheriffs' Association
LAUSD	Los Angeles Unified School District

LEGEND OF ABBREVIATIONS

P = PROPONENTS O = OPPONENTS

ABBREVIATION

ORGANIZATION

OCDE	Orange County Department of Education
PARS	Public Agency Retirement System
PERF	Public Employees Retirement Fund
RPEA	Retired Public Employees Association
SACRS	State Association of County Retirement Systems
SBMA	Supplemental Benefit Maintenance Account
SDCOE	San Diego County Office of Education
SEIU	Service Employees International Union
SLC	State Lands Commission
SSC	School Services of California
SSDA	Small School Districts' Association
START	State Teachers' Automation Redesign Team
TRB	Teachers' Retirement Board
TRF	Teachers' Retirement Fund
TRL	Teachers' Retirement Law
UTLA	United Teachers of Los Angeles

STANDING COMMITTEES OF THE ASSEMBLY/SENATE

Assembly PER&SS	Assembly Public Employees, Retirement and Social Security
Senate PE&R	Senate Public Employment and Retirement